Bills Committee on Securities and Futures and Companies Legislation (Structured Products Amendment) Bill 2010

Existing Regulatory Arrangements for Currency-Linked, Interest Rate-Linked and Currency and Interest Rate-Linked Instruments Issued by Authorized Institutions

Purpose

This paper briefs Members on the existing regulatory arrangements for currency-linked, interest rate-linked and currency and interest rate-linked instruments (ILCL instruments) issued by authorized institutions (AIs), including the relevant codes/guidelines issued by the Hong Kong Monetary Authority (HKMA), and the common types and respective quantities of these products in the Hong Kong market.

Regulatory arrangements

2. The HKMA regulates the sale of ILCL instruments as part of its regulation of the sale of investment products by AIs, regardless of whether the issuer is an AI or not.

3. The HKMA's approach to the supervision of AIs' sale of investment products involves issuing guidelines/circulars, conducting regular on-site examinations and undertaking off-site reviews to ensure compliance with regulatory requirements.

<u>Guidelines/circulars</u>

4. The HKMA has issued guidelines/circulars to provide practical guidance on the required standards and expected industry practices in the sale of investment products. Please refer to **Annex A** for a list of guidelines/circulars which contain the major regulatory requirements applicable to the sale of ILCL instruments.

5. As a general principle, the HKMA has required AIs in their sale of ILCL instruments to follow standards that are based on the requirements

imposed by the Securities and Futures Commission (SFC) on intermediaries in respect of the sale of securities products. Moreover, the HKMA's new regulatory measures that have been launched after the Lehman incident are also applicable to the sale of ILCL instruments by AIs. The major requirements are summarised below.

Marketing materials

6. According to the HKMA's circular of 13 July 2009 ("Selling of Investment Products"), for marketing materials of all ILCL instruments, AIs are required to follow standards similar to those issued by the SFC in respect of marketing materials, including the enhanced disclosure requirements as set out in the SFC's circular of 3 October 2008 to issuers of retail investment products and the SFC's letter of 5 December 2008 to issuers of SFC-authorised Collective Investment Schemes. In particular, marketing materials must be clear, fair and present a balanced picture with adequate and prominent risk disclosure in compliance with all applicable regulations.

Disclosure of product features and risks during the selling process

7. In addition to proper disclosure in the marketing materials, AIs are required to make clear disclosure of the key features and risks of investment products during the selling process. In particular, AIs should clearly disclose, among other things, the following to customers when marketing and selling ILCL instruments:

(a) These products are NOT equivalent to time deposits and are NOT protected deposits under the Deposit Protection Scheme in Hong Kong;
(b) Where applicable, the fact that these products are not principal-protected;
(c) Explanation of the nature of these products and whether they include any embedded derivatives and/or leverage, and the key risks of the investment including any risk of substantial losses being involved;
(d) Any disclosure of the maximum expected return of the investment must be accompanied by equally prominent and clear warning that the investor is subject to the risk of loss to his investment; and

(e) The health warning statement below:
"This is a structured product involving derivatives. The investment decision is yours but you should not invest in the [product name/type] unless the intermediary who sells it to you has explained to you that the product is suitable for you having regard to your financial situation, investment experience and investment objectives.".

In addition, AIs must have appropriate procedures to assure themselves that customers have a reasonable understanding of the nature, structure and risk of the products.

Other major requirements for the selling of ILCL instruments

8. Based on the SFC's requirements for the sale of securities products, the HKMA has required AIs to ensure proper controls, audit trails and management supervision of customer profiling, product due diligence and suitability assessment. Moreover, AIs in their sale of ILCL instruments have to adopt the new measures which have arisen from the recommendations of *Report of the HKMA on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies*. The measures include:

(a) AIs' sale of investment products is subject to segregation measures (i.e. conducted in investment corner instead of general banking area) to ensure clearer differentiation from traditional deposit-taking activities.
(b) The assessment of a customer's risk profile should be separated from the sales process, carried out by non-sales staff and audio-recorded. The customer should be provided with a copy of the risk profile and asked to confirm his agreement that the risk profile is accurate.
(c) The sales process and ancillary arrangements should be audio-recorded.
(d) AIs should draw investors' attention to the health warning statement which is set out in paragraph 7(e) above and printed in reasonable font size.
(e) In case of sales of investment products where there is a risk mismatch between the risk rating applied to the

product and the customer's risk profile, full and complete documentation should be retained of the reasons why the customer made the investment decision, the sales process should be audio-recorded, and endorsement should be sought from supervisory staff within the AI.

(f) AIs should perform continuous review of the risk rating of investment products, and where such review results in a higher risk rating being attributed to a product, the AI should disclose this to customers to whom it recommended and sold the product.

(g) AIs should put in place appropriate "mystery shopper" programme to test sales procedures.

(h) AIs should have adequate procedures and controls to ensure that frontline sales staff are not remunerated with bonuses calculated solely on the basis of financial performance but that other factors (including adherence to best practices guidelines and code of conduct) are in fact taken into account.

9. In order to offer additional protection to retail customers with less sophistication in unlisted derivative products (such as elderly customers and first-time buyers with high concentration), the HKMA has introduced the Pre-Investment Cooling-off Period (PICOP) arrangement which will allow such customers more time to consider the appropriateness of their investment before placement of an order. ILCL instruments are subject to the PICOP arrangements. AIs are required to implement the PICOP arrangements no later than 1 January 2011[1].

10. The HKMA will continue to work with the banking industry to review and, if necessary, enhance the relevant regulatory requirements. For example, the HKMA is working with the banking industry on a proposal to distribute Product Key Fact Statements[2] of certain unlisted investment products which are not subject to the SFC's authorisation regime (including ILCL instruments) to retail customers during the selling process.

[1] The implementation timeline for AIs has taken into account the necessary preparatory work to be carried out by AIs to implement PICOP.

[2] Product Key Fact Statements provide concise product summaries written in plain language to help investors understand the key features and risks of investment products.

On-site examinations

11. The HKMA conducts regular on-site examinations of AIs' sale of investment products (including ILCL instruments). The objectives of these examinations are to understand how AIs conduct their sale of investment products and to ensure AIs' compliance with the relevant regulatory requirements. During on-site examinations, the HKMA will perform sample checks and interview some of the relevant staff. The sample checks cover, among others, marketing materials, training materials, records of the sales process (such as audio records) and transaction documents etc.

Mystery shopper

12. In 2010, the HKMA and the SFC jointly introduced a mystery shopper programme to assist them in understanding the selling practices of intermediaries in respect of unlisted investment products. For the banking sector, the HKMA included ILCL instruments in the scope as well. The two regulators are now reviewing the results of the exercise.

Off-site reviews

13. The HKMA's on-site examination activities are supplemented by off-site reviews. The off-site reviews include following up any deficiencies in the systems of AIs that are discovered in on-site examinations or other sources, e.g. the AIs' internal reviews and mystery shopper exercises.

14. Starting 2010, all retail banks are required to submit to the HKMA a quarterly survey on sale of investment products. The purpose of this survey is to collect relevant information on the sale of investment products (including ILCL instruments) to retail banking customers to facilitate the HKMA in conducting off-site monitoring, prioritising supervisory resources, and determining the scope and focus of on-site examinations.

15. Where day-to-day supervisory work and/or the handling of complaints reveal(s) incidents that involve possible material adverse implications on the fitness and properness of bank staff who are registered

with the HKMA pursuant to section 20 of the Banking Ordinance[3], such cases are referred to the HKMA's Enforcement Department for considering necessary actions.

Common types of products

16. As explained in the Annex of LC Paper No. CB(1)466/10-11(01) (issued on 16 November 2010), the common types of ILCL instruments offered by retail banks to retail customers are: capital protected currency-linked deposits, non-capital-protected currency-linked deposits and capital protected interest rate-linked deposits. For the nature of these products, please refer to **Annex B**[4]. Instruments that are linked to both currency and interest rate are not common for retail customers in Hong Kong.

17. According to the information reported in the quarterly survey on sale of investment products, during the first half of 2010, retail banks in Hong Kong sold around HK$323 billion worth of currency-linked instruments and around HK$2 billion worth of interest rate-linked instruments to their retail customers.

Way forward

18. As explained in LC Paper No. CB(1)466/10-11(01), ILCL instruments are similar to ordinary banking deposit products but different from other structured products such as equity-linked instruments. The key requirements for structured products that fall under the regulatory remit of the SFO in seeking authorization from the SFC (e.g. eligibility of issuers / guarantors, criteria for reference assets, criteria for collateral) are irrelevant to ILCL instruments because: (i) the issuers are AIs (i.e. the direct counterparty to the ILCL instrument is an AI with substantive assets), (ii) the "reference assets" are currencies or interest rates, which are very different from shares or bonds, and (iii) as the direct counterparty to the ILCL instrument is an AI with substantive assets, there is no collateral.

19. In view of the above and the practices in other major markets where public offer of ILCL instruments are not subject to authorization

3 These are "relevant individuals" who are engaged by registered institutions to perform regulated activities as defined under the Securities and Futures Ordinance.

4 This is reproduced from Annex to LC Paper No. CB(1)466/10-11(01) for ease of Members' reference.

requirement, we consider that the interest of investors in ILCL instruments is properly safeguarded under the HKMA's current regulatory regime. It is not necessary to impose authorization requirements on ILCL instruments issued by AIs and their offering documents. Subjecting ILCL instruments issued by AIs to authorization would create unnecessary compliance burden on AIs and affect adversely the competitiveness of Hong Kong as an international financial centre, since ILCL instruments are products of the foreign exchange or treasury desks of banks which are part and parcel of the global currency market.

Financial Services and the Treasury Bureau
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Annex A

List of Guidelines / Circulars Issued by the HKMA in relation to the Sale of ILCL Instruments

Guidelines / Circulars	Date issued
"Selling of Renminbi Deposit, Investment and Insurance Products"	16 September 2010
"Implementation of Pre-Investment Cooling-off Period for Retail Customers"	20 May 2010
"Selling of Investment Products"	13 July 2009
"Implementation of recommendations in the HKMA's Report on Issues Concerning the Distribution of Structured Products Connected to Lehman Brothers ("the HKMA's Report")"	25 March 2009
"Report of the HKMA on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies"	9 January 2009
"Selling of Investment Products to Retail Customers"	This circular was initially sent to selected retail banks on 23 October 2008 and then re-issued as a circular on 11 December 2008
"Retail Wealth Management (RWM) Business"	3 March 2006
Supervisory Policy Manual Module IC-4 "Complaint handling procedures"	22 February 2002

Annex B

Nature of the Common Types of ILCL Instruments

Currency-linked instruments

- Currency-linked deposits (CLDs) are a common type of currency-linked instruments offered by retail banks to retail customers in Hong Kong. Both capital-protected CLDs and non-capital-protected CLDs are commonly offered to retail customers.

- For a typical capital-protected CLD, the customer chooses the Deposit Currency (i.e. the currency in which the initial deposit is denominated) and the Linked Currency (i.e. the reference currency). Upon maturity, the customer receives the full principal plus an interest in the Deposit Currency, while the amount of the interest depends on the exchange rate between the Deposit Currency and the Linked Currency at the fixing date.

- For a typical non-capital-protected CLD, the customer chooses the Deposit Currency and the Linked Currency. Upon maturity, the customer receives the full principal plus an interest in the depreciated currency. If the Linked Currency depreciates, the customer may suffer a loss of capital and the amount of loss depends on the extent of depreciation.

- The key risks for CLDs include possible adverse performance of the foreign exchange rate and the credit risk of the issuing bank. CLDs are not protected under the Deposit Protection Scheme of Hong Kong. Investors should be willing, and possess the financial capability, to have the principal amount locked up in the CLDs throughout the investment period.

Interest rate-linked instruments

- Interest rate-linked deposits (IRLDs) are a common type of interest rate-linked instruments offered by retail banks to retail customers in Hong Kong. A typical type of IRLDs for retail customers is capital-protected IRLDs. The customer chooses the reference interest index (e.g. USD 6-month LIBOR). Depending on the specific structure of the IRLD, during the investment period the customer may receive regular interest income, the amount of which depends on the performance of the reference interest index. Upon maturity, the customer receives the full principal plus an interest, while the amount of the interest depends on the performance of the reference interest index.

- The key risks for IRLDs include possible adverse performance of the reference interest index and the credit risk of the issuing bank. IRLDs are not protected under the Deposit Protection Scheme of Hong Kong. Investors should be willing, and possess the financial capability, to have the principal amount locked up in the IRLDs throughout the investment period.

Currency and interest rate-linked instruments

- Currency and interest rate-linked instruments are not common for retail customers in Hong Kong.